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Economic Conditions
Governmental Finance
United States Securities

New York, August, 1941.

General Business Conditions

THIS country's action in freezing Japanese assets here, coupled with similar steps by Great Britain and its Dominions, and the Netherlands Government, has widened the area of economic disturbance caused by the conflict in Europe and the Far East. At the request of the Chinese Government, its assets were also included in the blocking order. Trading in Far East currencies has been suspended, and Japan has announced the freezing of United States, British and Dutch funds in that country. While the action by the United States is not an embargo on the movement of goods between the countries concerned, it will have that effect except insofar as exchange and export licenses are granted.

The latest available information as to the extent of the short-term funds involved is contained in the U. S. Treasury report as of April 1, which showed Japanese balances here amounting to $91 millions, and United States balances in Japan of $67 millions. In addition, this country had, at the end of 1940, long-term investments in Japan valued at $45 millions and held over $100 millions of Japanese bonds. It has been stated officially that Japan is determined to continue interest payments on all Japanese Government direct and guaranteed bonds outstanding here.

While for years Japan had been our third largest customer and supplier of our imports, this trade has been declining in recent years as a result of the war in China, changes in the Japanese economic structure, and embargoes placed upon our exports of aircraft, armament, aviation gasoline, lubricating oil, steel scrap, and other products. Our total exports to Japan dropped from $289 millions in 1937 to $227 millions in 1940, and there has been a further sharp decline this year to the lowest level since 1933. Cotton and oil have been our chief exports during the past year. Imports from Japan, of which silk accounts for about two-thirds, declined from $204 millions in 1937 to $152 millions in 1940, with a further shrinkage this year. Our trade with Japan accounted for 5.6 per cent of our total exports last year, and 6.2 per cent of our total imports.

In individual industries, the chief effect of the freezing of funds will undoubtedly be in the silk hosiery and fabric lines, which employ some 175,000 workers. Both the Yokohama and New York raw silk markets have been closed, and it is expected that the price in this country will be fixed around the $3.00 per pound level which prevailed prior to the time of suspension. Stocks of finished and unfinished silk hosiery are sufficient for about five months' supply. Raw silk at warehouses represents only two months' supply, and mills have been ordered to limit their production to the rate heretofore current.

The problem of substitute materials may be met in part by synthetic yarns and cotton, but is complicated by the fact that the rayon industry has been booked solid for several months and producers' yarn stocks are but two days' supply at the rate of current consumption. It is reported that nylon facilities at present can furnish around 20 per cent of the women's silk hosiery needs, and du Pont's new plant will double the nylon supply when completed by the end of this year. The wider use of cotton appears likely, but the extent depends upon supplies of yarn in suitable grades and its acceptance by manufacturers and consumers.

Other important Far Eastern commodities such as sugar, rubber, spices, vegetable oils, and tin have risen in price since the new developments.

Domestic Production and Trade

Industrial production has continued to expand under the influence of the defense program, carrying the Federal Reserve Board's index (1935-39 = 100) up six points in June to a new high of 156; and the movement has continued in July. In industry generally the gains this year have been due to both non-defense and defense activity, with the point just beginning to be reached in numerous industries where the expanding defense program is forcing a shift from other work. The output of the steel industry is being turned more to defense

production, and non-defense orders are being dealt with according to priorities.

Under expansion plans announced by the Office of Production Management for the steel industry, the Carnegie-Illinois Steel Corporation (U. S. Steel) has contracted with the Defense Plant Corporation for an $85 million program, chiefly for armor plate, which will provide 1,800,000 tons annually of new ingot capacity at Homestead, Pennsylvania. The plants are expected to be active within one year, and will be operated under lease. Additional plans are being formed by the Steel Corporation to add 1,550,000 tons of ingot capacity in the Pacific Coast area, at a cost of around $100 millions, while the National Steel Corporation announced last month that it is adding 300,000 tons to the facilities of its Detroit unit. Pig iron production capacity is also to be increased, by 6,500,000 tons per year, which in time will be helpful in relieving the shortage in scrap.

Production and sales of consumers' durable goods such as automobiles, refrigerators, washing machines, etc. have risen to record levels during the first half year, stimulated by the expected curtailment to come. The automobile industry, which has already started on its $2 billions of orders for defense products, produced around 450,000 motor vehicles during July. Retail demand has kept the production rate on the 1941 models at high levels, and stocks of cars in the hands of dealers are low. The extent of curtailment on the 1942 models has not yet been finally determined.

Building contract awards in 37 eastern States are at the highest rate since 1929, according to the F. W. Dodge reports. In the first six months of this year, residential building was 37 per cent over the same period last year, non-residential (chiefly factory) gained 105 per cent, public works 23, utilities 98 and the total was up 57 per cent. For the first half of July, the average daily rate of contract awards was lower than in May and June, due to falling off in contracts for publicly owned building, but privately owned building reached a new high point.

The retail demand for practically all types of consumer goods has continued at high levels, with the sales of department stores and mail order houses running more than 20 per cent ahead of last year. Wholesale markets have been correspondingly active, with record buying of furniture, housewares, furs and clothing at Summer showings.

The Defense Program and Inflation

With every passing month fresh evidence unfolds of the vast dimensions of the program of rearmament upon which the country is embarked. When the program first got under way, after the collapse of France last year, the country was thinking in terms of a $10 billion plan. By January of this year, when the President presented his budget to Congress, the sights had been lifted to $28 billions. By March, when the lend-lease bill was adopted, the program had grown to around $40 billions, including aid to Britain. Now, within the past month, the President has requested an additional $4.7 billions for the Army and $3.3 billions for the Navy and Maritime Commission, which, with other funds voted by Congress, will push the total above $50 billions.

The foregoing figures represent the aggregate cost, as now projected, of the long-range national defense plan. Of course, such vast expenditures must be spread over a period of years. In the fiscal year just closed, actual cash outlays including lend-lease amounted to a little over $6 billions.

Last year non-defense expenditures showed disappointingly small reduction, so that total spending for the year was raised to $12.7 billions — an all-time high for any fiscal year save 1919. Although revenues expanded more than $2 billions to a new peak of $7.6 billions, under the combined influence of tax increases and the rise in business activity and incomes promoted by government expenditures, the year closed with the deficit over $5 billions.

For the current fiscal year which began July 1, defense expenditures are expected to more than double — to $15.5 billions — according to revised budget estimates issued May 31. With non-defense expenditures practically unchanged, total expenditures are forecast at $22 billions, or far surpassing any spending record in our history.

Revenues also will be higher, the Treasury estimating $9.4 billions on the basis of existing taxes, which would mean a deficit of something over $12.8 billions. While an additional $3.5 billions of revenues is expected from the tax bill now pending in Congress, not all of this will be available this fiscal year; and even if it were the country still would face a deficit of well over $9 billions.

The Growing Threat of Inflation

These budget figures, with their billions of contemplated expenditures and deficit, outline the magnitude of the problem confronting the Treasury and the industries during the coming year. How can these huge sums be raised and spent, and the goods produced, without a great inflation?

It is evident that the people are becoming more and more concerned about inflation. They remember what happened in the last war, when prices rose rapidly and far under the impact of war demands and credit expansion, and then collapsed in a disastrous aftermath that spread disorder and ruin in all directions, and from which it took years to recover. Agriculture in particular was hard hit, as the boom in

prices led, as it always does, to over-expansion and debt. People hope never to go through such experiences again.

When the new war broke out in September, 1939, there was a temporary flare-up of the inflation psychology, but it quickly subsided under the influence of disrupted markets, ample supplies of goods and large unused productive capacity in almost every line. Even after the defense program got under way people were slow to appreciate fully its inflationary possibilities. Much was said about everyone having learned a lesson in self-restraint in 1920 and 1929, and much about the effectiveness of government controls. In other words, somehow or other, "things were going to be different this time."

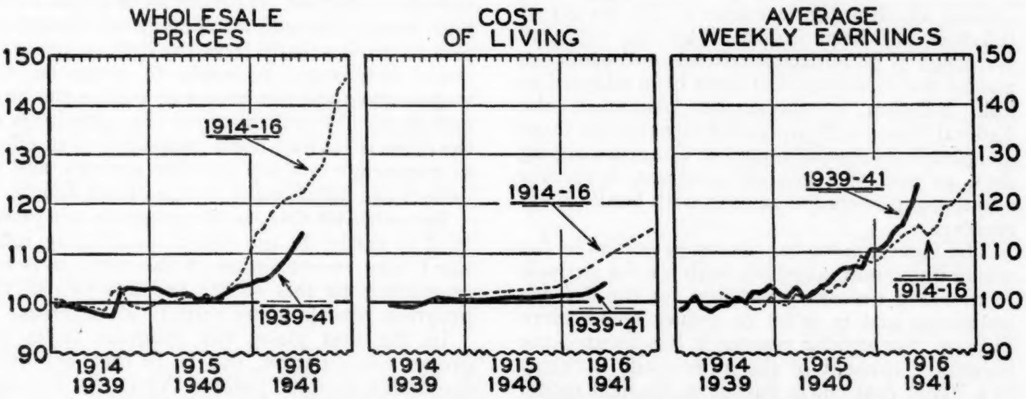
Gradually, however, this attitude has changed as the defense program has advanced and the sums budgeted for spending have grown larger and larger. Moreover, symptoms of inflation are beginning to appear in many directions, and are having their effect upon the public psychology. Commodity prices, which advanced sharply at the outbreak of the war, and then fell back, are now moving up with renewed vigor to new high levels. Sensitive wholesale prices, as measured by the Bureau of Labor Statistics index of 28 staples, have advanced 44 per cent on the average from last Summer's low to a point 50 per cent higher than at the outbreak of the war. The Bureau's more comprehensive wholesale index covering 887 commodities, while naturally less volatile than the sensitive barometer, is showing much the same trend — up 14 per cent since last Summer and 17 per cent since August, 1939. With the advance that has taken place in wholesale prices, and wages increasing all around, even the slow moving cost of living index has been affected, and in June, according to computations of the National Industrial Conference Board, stood 5 per cent above a year ago.

It is true, of course, that not every rise of prices can be labelled inflationary; and no doubt many people who associate the term chiefly with currency irregularities will stress the importance in the present instance of such non-monetary influences upon prices as farm legislation, wage increases, ocean shipping difficulties, etc. Granting that the line between a "normal" price rise or price recovery, and inflation, is often hard to draw, it is nevertheless well to bear in mind that inflation can result from non-monetary as well as monetary causes. Any interference with production, or arbitrary action by any group that raises costs, can be as much a factor in the inflationary process as finance, since both operate upon the supply-demand equation, though from different angles. Under the conditions of high pressure demand now developing, one influence reacts upon another, and so sets the inflation spiral going.

1914-16 and 1939-41 Price Trends Compared

In interpreting current price movements, it is interesting to observe the similarity in the behavior of the price indexes since the outbreak of the present war and in the early stages of the last war. As indicated by the diagram at the foot of the page, prices in both periods experienced an initial spurt at the outbreak of war, followed by an interval of pause and reaction lasting about a year. Then they started up again in both periods, and while the advance was slower at first in 1940-41 than in 1915-16, it has speeded up recently to a rate not far behind that of the earlier period.

Curves of the cost of living in the two periods conform to the same general pattern, though showing more regularity and a time lag, as to be expected. Trends of average



Wholesale Prices, Cost of Living, and Average Weekly Earnings of Factory Employes; 1914-16 (1914 = 100) and 1939-41 (1939 = 100). Source: Wholesale prices — U. S. Bureau of Labor Statistics; Cost of living — National Industrial Conference Board; Average weekly earnings — N. Y. State Dept. of Labor for employes of manufacturing industries in N. Y. State.

weekly earnings of factory workers, which reflect wage payments and general business activity — both having an important bearing upon prices — are likewise shown and present a still more striking parallelism, except that the rise lately has been even more rapid than in 1916.

It is evident that, despite many dissimilarities, the two periods are more basically alike than perhaps has been generally realized. In both cases the outbreak of war found the economic system operating below capacity, and it was some time before the initially disturbing influence of war could wear off and business begin to feel the stimulus of mounting war orders. So long as supplies appeared ample and the industries had room to expand, prices did not rise. By the latter part of 1915, in the last war, the boom psychology was on, demands were outrunning supplies, and prices were already reflecting the change.

A like situation appears to be developing today. Up to now prices have been rising largely as a result of anticipatory buying, scarcity and higher shipping costs of numerous imported commodities, and a price-raising agricultural policy. For the past year we have been steadily taking up idle productive capacity, but now have reached a stage where further expansion of defense output can come only as new productive facilities are brought into use and at the cost of increasing interference with non-defense output available for civilian consumption. At the same time, the demand for goods, represented by the huge sums being poured out by the Treasury, is constantly growing. It is at this point that the danger of inflation becomes more serious. In fact, many are now raising the question as to whether the stage is not set for a repetition of the 1914-1920 experience unless adequate steps are taken to prevent it.

Government Efforts to Avert Inflation

That Washington is aware of the danger of inflation has been indicated by the repeated warnings of government officials and agencies, and by the measures that have been adopted to hold inflation in check. In December, the Federal Reserve Board called attention to these dangers in its special report to Congress urging that, as part of a general program, it receive additional powers for dealing with bank excess reserves.

The Government has set up priorities in the use of important materials both for the purpose of assuring necessary supplies for the defense industries and in order to reduce competitive buying. For similar reasons it has secured the voluntary consent of the automobile industry to a 20 per cent cut in output in the next model year; and recently Price Administrator Leon Henderson has asked that this cut be increased, and that the curtailment include also production of mechanical refrigerators and washing machines.

Still further, the Government has been attempting direct price control, through Mr. Henderson's Office of Price Administration and Civilian Supply, by establishing price "ceilings" on a wide variety of products. This division's authority, which heretofore has lacked "teeth" by reason of deriving from executive order rather than specific statute, is intended to be clarified and broadened by new legislation to control prices and rents requested of Congress by the President on July 30.

Important steps have also been taken to strengthen the public finances. The Government has raised taxes twice in the past year, and in amounts calculated to produce $2 billions of additional revenue (and likely to produce much more because of unexpectedly favorable tax yields). It has lowered the personal exemptions on the income tax, thus broadening the tax base by increasing the number of federal income tax payers. It is promoting the sale of defense savings bonds to individual and institutional investors, in the effort not only to encourage thrift, but also to divert current purchasing power to the Treasury and lessen the dependence upon bank credit in financing the deficit. And finally, there is the new tax bill before Congress proposing further steep increases in the already high federal tax rates, to yield another $3.5 billions.

Is the Program Adequate?

The foregoing program reflects both a realization of danger and a vigorous attempt by the Government to meet it. Much of the program unquestionably is good and should have general support. Certainly, in the present emergency, there is strong argument for some degree of priority and price control, particularly of strategic materials indispensable to the defense industries. We must all be prepared for high taxes. No individual or group should expect to profit greatly from the defense program —and this ought to apply to everyone, the wage-earner and the farmer as well as the business man. All will approve the soundness of the defense savings bond campaign, as an effort to encourage and tap genuine savings, and so temper the inflationary effects of the deficit.

But with all this, is the program adequate? Will it really do the job of preventing inflation? The recent action of the markets is not reassuring on this score; and analysis of the program reveals some serious weaknesses.

In the first place, the program lacks the proper coordination, and is, in fact, definitely conflicting at some points. While Mr. Henderson's division has been endeavoring to prevent a run-away price rise by establishing price "ceilings" for various important products,

Congress has taken an opposite tack in enacting 85 per cent parity loans for farmers. This has given a sharp boost to agricultural prices, which affects raw material costs and basic elements in the cost of living — the latter, in turn, affecting wages. An indication of the temper of Congress where agricultural prices are concerned was afforded last month when the cotton market, which had risen above 17¢ for the first time since 1930, broke sharply on reports that the Department of Agriculture was considering the release of some loan cotton to retard the price rise. Although the Government, through the Commodity Credit Corporation, holds some 6,000,000 bales of cotton, some of which could now be sold, farm bloc senators were up in arms against the suggestion, and are now moving for legislation to freeze government-held cotton and wheat for the duration of the war. Upon this news and other evidence of growing Congressional opposition to any fixed ceiling on farm prices, the cotton market recovered to new highs.

Still another inconsistency is the failure of price-control efforts to include wages, although Mr. Henderson admits that wage increases, along with farm parity loans and ocean freight rates, have been the real cost-increase items. Without control of such basic factors in production and living costs as farm prices and wages, how can any attempt to control inflation through price-fixing be successful?

In the second place, the program, as so far revealed, has the still more fundamental defect of failing to attack the evil of inflation at its source—which is the putting of purchasing power into the market in excess of the supply of goods to be bought.

Speaking before the New York Housewares Manufacturers Association at Atlantic City on July 14, Mr. Henderson himself said: "Before long now there will be more purchasing power running around hunting something to buy than there are goods available. If that occurs to substantial degree, no power on earth can prevent inflation."

Continuing, Mr. Henderson said:

> For that reason the government must sop up some of this extra purchasing power and it can do so in many healthy ways. It must increase taxes, thus helping to pay for defense. It can stimulate savings—thus providing a back-log for the future when first attention is not being given to making merchandise of death. Consumer credit must be kept from expanding. At the same time, increased attention must be given to making it easier for industries which do not compete with defense, to expand their production. In the meantime, the government must stiffen its control over prices—no matter how ornery and belligerent the outcries become.

The above quotation indicates that Mr. Henderson has no illusions as to the ability of price controls *alone* to prevent inflation. And all experience shows that Mr. Henderson is justified in his skepticism. The attempt to deal with inflation by price-fixing is an old story on the records of history that invariably has ended in failure. Only in Germany in the present war has price-fixing seemed to have a degree of success—accompanied, however, by a system of espionage and punishment far beyond anything conceivable in a democratic country. Moreover, the full history of the German experiment has yet to be written.

The foregoing is not meant to imply that a well-devised system of priorities and price controls has no place in an anti-inflation program; but simply that unless attention is given to the fundamental source of inflation—more buying power than goods—the battle is lost at the start. On the other hand, if we do attend to the fundamentals, the problem of the particular priorities and price controls will be relatively simple.

The Heart of the Problem

We come back, then, to the heart of the problem, which is to keep purchasing power from expanding out of all proportion to the amount of goods to be had. Mr. Henderson, in the quotation above, mentions a number of ways of doing this; and by all odds the best — so far as possible — is by increasing production.

Certainly, every effort consistent with the primary goal of speeding defense production should be made to increase the output of goods that people can buy. With our manufacturing industries as a group still operating at an average of only 41 hours a week, and with frequent interruptions due to strikes and disputes over wages and working conditions, who can doubt that many of our so-called shortages would be greatly relieved if everyone could be made to see the importance of doing as much rather than as little as possible, and of avoiding time-wasting bickering with one another? No one is more vitally concerned in increasing production than the wage-earner, for it is to him that the increased income due to defense is largely flowing. Yet unless there are more goods to be bought, the effect is simply a rise of prices all around, which yields him no economic benefit, or taxes that take away part of his increased income before he can spend it.

By all means, therefore, let us increase production to the fullest extent possible. Yet, despite all that can be done in this sector, we are still forced to recognize that, where the program is so great, our ability to have both "guns and butter" is limited. Hence the alternative must be to restrict in some degree the supply of purchasing power at the disposal of the public.

This could be done in three principal ways:

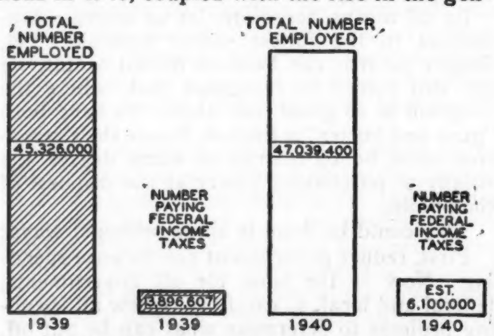
First, reduce government non-defense spending. Now is the time for all governments, federal and local, to carefully review all spending projects to determine what can be put off, not only in the interest of present defense needs, but to create a reserve of such projects

when the defense program is completed. While it is true that some reductions have been made, other and new ways of spending have been adopted, so that on balance Congress has been unwilling to economize of its own volition, and the Administration has been unwilling to insist upon it. Non-defense spending this year, according to the latest budget estimates, will be as large as last year.

Second, sell more bonds to individual investors. Already the Treasury is accomplishing much along these lines in its sale of defense savings bonds. However, since high pressure selling methods have been avoided, a substantial proportion of these sales have reflected merely a shifting of assets, or new investments, by people and institutions already of the investor class. Unless a way can be found to reach more broadly people who otherwise would spend their money, the effectiveness of savings bonds as an anti-inflation device will tend to be limited. It is interesting that President Green of the American Federation of Labor has advocated a government sponsored, mandatory savings system for defense workers, to cushion the effects of a let-down in employment when the defense program is completed, and to prevent inflation.

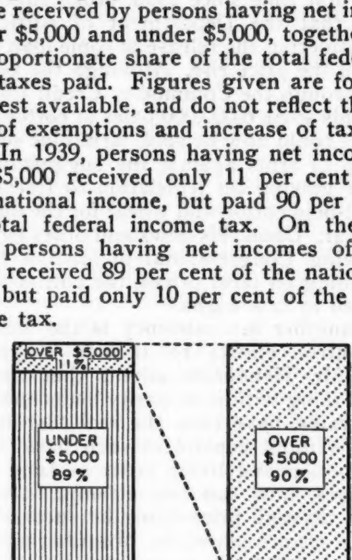
We are thus thrown back upon the third principal inflation preventive—taxation. However, in the levying of taxes, it is important to consider what kinds of taxes are appropriate to the situation. For taxes, to be effective for the purpose desired, must cut across the stream of spending; in other words, they must be levied over a broad base and reach the great bulk of consumer incomes. This is precisely what our federal income tax system at present does not do, as indicated by the following diagrams.

As the first diagram shows, out of a total number of persons gainfully employed in the United States in 1939, amounting to over 45,000,000, the number which paid taxes on 1939 incomes was only 3,900,000, or less than 9 per cent. While the lowering of personal exemptions in 1940, coupled with the rise in the general average of incomes, increased the number of federal income taxpayers to an estimated total of 6,100,000, the percentage of such taxpayers to the 47,000,000 persons gainfully employed in 1940 was still only 13 per cent.



Total Number of Persons Gainfully Employed in 1939 and 1940, and Number Paying Federal Income Taxes for Those Years.

Illustrative also of the narrowness of the tax base, and of the concentration of the tax burden in the upper brackets, is the next diagram showing the proportion of the total national income received by persons having net incomes of over $5,000 and under $5,000, together with the proportionate share of the total federal income taxes paid. Figures given are for 1939, the latest available, and do not reflect the lowering of exemptions and increase of taxes last year. In 1939, persons having net incomes of over $5,000 received only 11 per cent of the total national income, but paid 90 per cent of the total federal income tax. On the other hand, persons having net incomes of under $5,000 received 89 per cent of the national income, but paid only 10 per cent of the federal income tax.



Percentage of National Income Received by Persons Having Net Income Over $5,000, and Under $5,000.

Percentage of Federal Income Taxes Paid by Persons Having Net Income Over $5,000, and Under $5,000.

Distribution of Individual Income, and of Federal Income Taxes Paid, in 1939.

In other words, under our existing tax system, five out of six of our gainfully employed population pay no federal income tax, with those having incomes of less than $5,000 contributing only a minor portion of the total tax. Yet it is precisely in this low income group that the gain in income due to the defense program has been the largest. Payrolls in the manufacturing industries are running at all-time peak levels, 51 per cent higher than a year ago. Aggregate income payments to individuals in the country are reported by the Department of Commerce to be running at the record rate of $86,000,000,000 a year, or more than $1,000,000,000 per month above last year. Moreover, of this increase, wages and salaries (covering all industries) were the leading influence, rising 18 per cent over last year, as against gains of only 9 per cent in business income and only 5 per cent in dividends.

The foregoing does not mean, of course, that people who escape federal income taxes pay no taxes. They are affected by many types of

indirect taxes, and by the extent to which all taxes enter into the cost of living. In this connection, mention perhaps should be made of estimates published by the Temporary National Economic Committee showing the total tax burden (both federal and local) in relation to income to be heavier in the income groups below $1,000 than in the groups from $1,000 t- $10,000, and increasingly progressive thereafter. Since these estimates, however, were based on small samplings, and involved a number of controversial assumptions — viz. the treatment of social security payments .s taxes rather than savings, and the forward shifting of all real estate and business taxes (other than those based on income) to the consumer — they must be accepted with reservation.

Allocation of Additional Taxes

The foregoing facts and figures point unmistakably to the broad base tax program that is now called for by the conditions. For the past several years of incomplete utilization of our productive resources, we have been following tax policies especially designed to *promote* consumer spending and *accelerate* business recovery. This was to be accomplished by taxing the corporations and higher individual incomes, which were presumed to be saving too much, and distributing the proceeds, through government expenditures, to the low income groups where it would be spent. As recently as last January the President in his budget message expressed opposition to a "tax policy which restricts general consumption as long as unused capacity is available and as long as idle labor can be employed."

How greatly the situation has changed is indicated by the statements of Mr. Henderson and by Secretary Morgenthau who was quoted last month as saying that "unless the manufacture of goods for civilian consumption is soon sharply restricted, it will be impossible for the United States to spend on defense during the present fiscal year more than half of what Congress has appropriated."

An admirable statement of what the new tax policy should be was given by Mr. Morgenthau before the House Ways and Means Committee in April when he suggested the following four objectives:

> To pay as we go for a reasonable proportion of our expenditures; to provide that all sections of the people shall bear their fair share of the burden; to help mobilize our resources for defense by reducing the amount of money that the public can spend for comparatively less important things; and to prevent a general price rise by keeping the volume of purchasing power from outrunning production.

Actually, however, the new tax bill, as now introduced into the House, falls far short of meeting these requirements. While it is true that the bill calls for increased taxes in numerous consumption items, the major portion of the expected increase in revenue is to come from the corporate and individual income tax without lowering the exemptions. In other words, the increased taxes are to be levied upon the same group that is already paying taxes, instead of bringing in large numbers of new taxpayers. The bill proposes to carry over into a boom period a system of taxation evolved during the years of depression when the aim was to stimulate consumer spending.

While the new tax bill may produce the desired $3.5 billions of revenue to the Treasury, it can do little to meet the other objectives of limiting consumer spending and checking the rise of prices already under way. Tax increases upon people who have been saving a portion of their incomes will not prevent inflation, for the reason that they fail to cut deeply into the broad stream of individual purchasing power. Such taxes will merely divert some of the funds that otherwise would have gone into investments — including defense savings bonds.

In order to accomplish the objectives named by Secretary Morgenthau, taxation must reach the groups of the population which are receiving the bulk of the purchasing power being pumped out by the Treasury. This might be done in various ways, including a lowering of personal exemptions and credits, a tax on gross income, an increase in social security payroll taxes, a general sales tax or a widespread extension of excise taxes.

Another alternative would be some form of "forced savings" — similar to that adopted in England — whereby a portion of wages is deducted at the source and loaned to the Government, to be returned after the war. Such a plan would place substantial funds at the disposal of the Treasury for financing the defense program, would siphon off excess purchasing power and would provide the worker with a savings reserve against a possible postwar depression.

Inflation a Political as Well as Economic Problem

In considering these various alternatives, it has to be recognized that the control of inflation presents a political as well as an economic problem. There have been any number of able discussions on the economic side; the real difficulty lies in getting public officials to act in ways that may incur popular resentment. The fact is that nobody likes taxes; everyone likes to get more pay or see the things which he has to sell go up in price. Hence the tendency of governments always to apply controls timidly and inadequately — to crack down on the few rather than the many, not only with respect to taxes but also to price-fixing and other controls. Yet the prevention of inflation is an objective of vital concern to all classes — labor and agriculture as well as business — for all groups suffered grieviously from its consequences in the last depression.

To take the necessary steps to avoid inflation requires political courage. Yet the need for such action is overwhelming, not only to avoid the damaging effects of inflation upon the public morale and the pyramiding of costs during the present defense emergency, but looking also to the post-war period. For none of the plans now being talked of for avoiding a great deflation when the defense program is over would be nearly so effective as the avoiding of inflation now. It is encouraging to have the recent statement by Chairman Doughton of the House Ways and Means Committee that a broadening of the tax base through lower income tax exemptions and the levying of some form of general sales tax is likely to be a feature of next year's revenue measures. The question is, whether it is not too dangerous to wait.

The Half Year's Profits

Reports of leading corporations for the first six months show in a majority of cases an increase in net profits as compared with the first half of last year, accompanying a largely increased volume of business. Numerous manufacturing companies which were still in the expanding phase reported sales increases ranging from 25 per cent to more than 100 per cent over last year, with sharp increases in net profit despite the rise in operating expenses and taxes. In those lines which experienced only a moderate expansion in sales or which were already operating practically at capacity, the increases in wages and taxes this year cut deeply into profits and in many instances caused the balance after taxes to be lower than a year ago.

A tabulation of the published statements of 360 leading companies engaged in manufacturing, mining, trade, service and construction shows combined net profits, less deficits, of approximately $785,000,000 after taxes in the first half year, which compares with $652,000,000 for the same companies in the first half of 1940 and represents an increase of 20 per cent.

This group had an aggregate net worth of $12,301,000,000 at the beginning of 1941, upon which the half year's profits were at an annual rate of 12.8 per cent, compared with a slightly smaller net worth and a rate of 10.8 per cent a year ago. The accompanying summary shows the comparative figures for 1940-41 by major industrial groups for which semi-annual reports of representative companies are available.

Separate quarterly figures issued by 290 of these companies give a combined total of $326,000,000 net profit after taxes in the second quarter of this year, compared with $328,000,000 for the same companies in the first quarter and $259,000,000 in the second quarter of 1940. The slight decrease this year from the first to the second quarter is counter to the usual seasonal tendency, and may be attributed to the steadily increasing costs, the larger tax re-

PROFITS OF LEADING CORPORATIONS FOR THE HALF YEAR

Net Profits Are as Reported, After Depreciation, Interest, Taxes, and Other Charges and Reserves, but Before Dividends. — Net Worth Includes Book Value of Outstanding Preferred and Common Stock and Surplus Account at Beginning of Each Year.

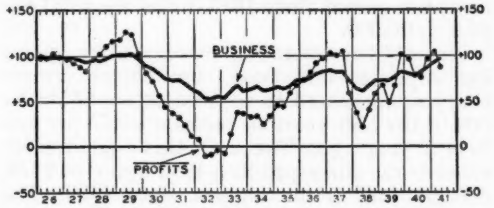
(In Thousands of Dollars)

No.	Industrial Groups	Net Profits Half Year 1940	Net Profits Half Year 1941	Per Cent Change†	Net Worth January 1 1940	Net Worth January 1 1941	Annual Rate of Return % 1940	Annual Rate of Return % 1941
7	Baking	$ 7,970	$ 7,608	— 4.5	$236,681	$237,381	6.7	6.4
14	Food products — misc.	34,974	39,194	+12.1	534,953	541,084	13.1	14.5
7	Beverages	8,132	9,088	+11.8	129,922	136,421	12.5	13.3
17	Textiles and apparel	7,862	10,654	+35.5	176,025	169,854	8.9	12.5
7	Wood products	1,326	4,515	+	59,360	61,281	4.5	14.7
14	Paper products	6,883	7,892	+14.7	159,185	164,248	8.6	9.6
28	Chemicals, drugs, etc.	92,082	94,021	+ 2.1	1,300,054	1,331,123	14.2	14.1
11	Petroleum products	141,070	135,227	— 4.1	2,666,501	2,671,664	10.6	10.1
13	Stone, clay and glass	12,220	14,807	+21.2	221,718	223,378	11.0	13.3
26	Iron and steel	61,915	126,111	+	2,447,002	2,491,210	5.1	10.1
12	Building equipment	7,536	11,519	+52.9	224,738	219,780	6.7	10.5
14	Electrical equipment	42,863	47,662	+11.2	637,133	652,618	13.5	14.6
10	Hardware, tools, etc.	4,664	6,373	+36.6	82,764	85,572	11.3	14.9
27	Machinery	16,377	21,204	+29.5	158,471	175,062	20.7	24.2
4	Office equipment	8,232	11,557	+40.4	133,264	136,668	12.4	16.9
10	Railway equipment	9,498	13,051	+37.4	173,403	182,930	11.0	14.3
9	Automobile	116,701	125,860	+ 7.8	1,149,449	1,190,568	20.3	21.1
19	Auto equipment	10,781	14,293	+32.6	111,478	120,197	19.3	23.8
36	Metal products — misc.	20,354	29,603	+45.4	220,815	246,232	18.4	24.0
19	Misc. manufacturing	9,947	18,119	+82.2	316,893	326,785	6.3	11.1
304	Total manufacturing	621,387	748,358	+20.4	11,139,809	11,364,056	11.2	13.2
10	Coal mining	830*	2,698*	+	201,314	206,617	0.8	2.6
9	Metal mining	8,787*	9,649*	+ 9.8	164,037	167,564	10.7	11.5
9	Mining, quarrying — misc.	9,276*	9,536*	+ 2.8	124,419	121,393	14.9	15.7
16	Trade (wholesale and retail)	3,459	5,982	+72.9	209,447	211,858	3.3	5.6
12	Service and construction	8,389	8,317	— 0.9	226,955	229,531	7.4	7.2
360	Total	$652,128	$784,540	+20.3	$12,065,981	$12,301,019	10.8	12.8

D-Deficit. *Before certain charges. †Increases or decreases of more than 100 per cent not computed.

serves required by the proposed new revenue act, and the fact that the steel and a number of other industries were already operating at capacity in the first quarter. Second quarter profits showed an increase of 26 per cent over the same period of last year, which was considerably higher than the first quarter increase, amounting to 17 per cent.

An index of the course of quarterly profits over a period of years, computed from the rate of return on net worth of 200 large industrial corporations and adjusted for seasonal variation, is given in the accompanying chart, together with the index of industrial production computed by the Federal Reserve Bank of New York and adjusted for both seasonal variation and long-term trend:



Quarterly Index of Industrial Corporation Profits and The Federal Reserve Bank of New York Index of Production. 1926 = 100

Changing Factors in Profits

An examination of the uneven changes in profits in the various manufacturing industries indicates the influence of four important factors, — sales, wages, materials and taxes. Increases in production costs were much more pronounced in the second quarter of this year than in the first. In the important steel group, for example, which was affected also by the coal strike in April, net profits declined in the second quarter, and the comparative gain over a year ago was much less than the gain in the first quarter, as may be seen from the combined results given below:

Net Profits After Taxes of 23 Leading Iron and Steel Manufacturing Companies

(In Thousands of Dollars)

	1940	1941	Change
First Quarter	$30,018	$71,767	+139%
Second "	31,982	52,029	+ 63
Half Year	$62,000	$123,796	+100

Changes in the half year's sales of 40 large manufacturing companies given in the accompanying list illustrate the heavy expansion in shipments that took place, particularly in those lines affected by the national defense program. Combined sales of the group aggregated $3,060,000,000 in the first half year, and increased $878,000,000 or 40 per cent over the first half of last year.

Sales of manufacturing companies, including capital goods and other countless items for the

% Change in Half Year's Sales, 1940-1941

Manufacturing		Retail Trade	
Air Reduction Co.	+49.8	American Stores Co.	+11.2
Amer. Steel Foundries	+61.1	Barker Bros. Corp.	+16.2
Amer. Stove Co.	+40.0	Bond Stores	+42.7
Atlantic Refining Co.	+ 5.3	Colonial Stores	+20.2
Atlas Powder Co.	+75.0	Consol. Retail Stores	+12.7
Beatrice Creamery Co.	+16.0	Crown Drug Co.	+ 3.1
Caterpillar Tractor Co.	+47.2	Dixie Home Stores	+21.4
Cluett, Peabody & Co.	+24.0	Edison Bros. Stores	+23.6
Container Corporation	+26.8	W. T. Grant Co.	+14.0
Continental Baking Co.	+ 4.3	H. L. Green Co.	+ 8.3
Continental Steel Corp.	+59.9	Interstate Dept. Stores	+23.3
Crosley Corporation	+49.7	Jewel Tea Co.	+37.9
Doehler Die Casting Co.	+93.9	G. R. Kinney & Co.	+ 6.1
E. I. du Pont & Co.	+44.2	S. S. Kresge Co.	+ 8.7
General Electric Co.	+56.7	S. H. Kress & Co.	+15.2
General Foods Corp.	+18.2	Kroger Groc. & Bak.	+12.6
General Motors Corp.	+46.7	Lane Bryant, Inc.	+16.6
General Tire & Rubber	+61.2	Lerner Stores Corp.	+11.7
B. F. Goodrich Co.	+45.2	McCrory Stores Corp.	+10.4
Hazel-Atlas Glass Co.	+18.5	McLellan Stores Corp.	+14.6
Hercules Powder Co.	+39.8	Melville Shoe Corp.	+11.7
International Shoe Co.	+22.9	Montgomery Ward	+20.9
Johns-Manville Corp.	+45.7	G. C. Murphy Co.	+16.1
Kimberly-Clark Corp.	+12.3	National Tea Co.	+ 9.2
Lone Star Cement	+38.4	Neisner Brothers	+10.0
Mead Corporation	+21.7	J. J. Newberry Co.	+14.6
Glenn L. Martin Co.	+36.1	J. C. Penney Co.	+17.0
Minn.-Honeywell Reg.Co.	+58.1	Peoples Drug Stores	+14.1
Monsanto Chemical Co.	+53.3	Reliable Stores Corp.	+29.5
Natl. Cash Register	+10.0	Safeway Stores	+10.7
Natl. Gypsum Co.	+42.8	Schiff Company	+10.1
Natl. Lead Co.	+48.8	Sears, Roebuck & Co.	+27.5
Otis Elevator Co.	+21.4	Spencer Shoe Corp.	+17.6
Phillips Petroleum Co.	+ 8.6	Spiegel, Inc.	— 0.3
Remington-Rand, Inc.	+31.4	Sterchi Brothers	+29.3
Shell Union Oil Co.	+ 9.8	Union Premier Food	+11.1
Simmons Company	+46.8	Un. Cigar-Whelan Strs.	— 4.5
Skelly Oil Co.	+28.0	Walgreen Company	+10.4
Wesson Oil & Snowdrift	+31.8	Western Auto Supply	+25.5
White Motor Co.	+70.6	F. W. Woolworth Co.	+ 8.9

defense program, have of course expanded much more sharply than have retail sales of consumers' goods. Substantial gains nevertheless were made by most of the 40 large chain store, department store and mail order houses which are also given in the list. This group had aggregate sales of $2,110,000,000 in the first half year, which was $296,000,000 or 16 per cent over that of a year ago.

The large further expansion of output in many manufacturing industries this year permitted the productive capacity to be utilized to practically full extent. This tended to lower unit costs, and aided the corporations in offsetting the increase that took place in wage rates, cost of materials purchased and in taxes. Although the rise in costs was accompanied in many cases by an increase in selling prices, the recent establishment by the Government of "ceilings" on the selling prices of many types of finished and semi-finished goods has resulted in a substantial narrowing of profit margins.

For the group of 40 well-known manufacturing companies listed above, many of which are working on large defense orders for the Government, the net profit (including income from investments and other operations as well as from sales) after taxes in the first half year 1940 amounted to 12.1 per cent of sales, but the margin declined to 9.2 per cent in the first half year 1941, despite the large increase in volume of business this year.

Rise in Federal Taxes

Details as to tax reserves are available for 135 of the manufacturing companies included in our summary and afford the following striking contrast with a year ago:

Federal Income and Excess Profits Taxes of 135 Leading Manufacturing Corporations for the First Half Years, 1940-41
(In Thousands of Dollars)

	1940	1941
Net income before taxes	$466,045	$899,574
Federal income and excess profits taxes	129,738	459,476
Net profit after taxes	$336,307	$440,098

It will be seen that the combined net income before taxes of approximately $900,000,000 in the first half year was $434,000,000 larger than the corresponding figure for 1940. Deductions for federal income tax and excess profits tax liability, including reserves set up against the increase in rates provided in the pending revenue bill, amounted to $459,000,000 this year and were more than three times as large as the deductions in the first half of 1940. In other words, the increase of $330,000,000 in taxes absorbed 76 per cent of the increase in net income before taxes. Last year these companies reserved about $0.39 for taxes to every $1.00 of net profit after taxes that was available for payment of dividends on preferred and common stocks and for improvements in plant and equipment; this year the same companies reserved $1.04 in taxes to every $1.00 that was left after taxes.

These figures, which are subject to adjustment at the close of the year, cover only the federal taxes upon income, and thus do not measure the full burden of corporate taxes, including numerous state and local taxes upon income, franchises or sales, as well as social security taxes, unemployment compensation taxes, real estate taxes, etc. Moreover, even the reserves set up for federal income and excess profits taxes so far this year may prove to be inadequate, as happened in 1940, because of subsequent increases in tax rates that were made retroactive.

Public Utility Reports

A group of 25 leading systems supplying electricity, gas and other services and reporting for the twelve months ended June 30, 1941, showed total operating revenues of $998,000,000 and an increase of 5 per cent over the preceding twelve months. Expanding industrial activity has carried the consumption of electricity this year to a new high level more than 60 per cent above the 1929 average.

A major portion of the gain in revenues, however, was absorbed by the increase in operating expenses and taxes. Net income after taxes for the group amounted to $155,000,000 and increased but 3 per cent, while almost one-third of the individual systems showed declines in the net.

Recovery in Railroad Traffic

The railroads this year have made an outstanding record in handling the heavy increase in freight and passenger traffic resulting from the defense program and the expansion of general business activity. Although freight carloadings in the first half year were 17 per cent above the same period in 1940 and 30 per cent above 1939, the railroads have provided the fastest and most efficient service in their history.

Total operating revenues of all class 1 railroads for the first six months were approximately $2,424,000,000, an increase of 21 per cent over last year, and were the largest for any such period since 1930, when the total was $2,693,000,000.

Net railway operating income, after operating expenses and taxes, but before interest charges, amounted to approximately $434,000,000 in the half year, an increase of 77 per cent over a year ago. The total this year actually exceeds the corresponding 1930 figure of $378,000,000, and is the highest since 1929. This recovery of earnings has occurred despite lower freight rates and volume of traffic, and despite higher wages, taxes and other expenses. For example, average freight revenues per ton-mile in 1940 were 11 per cent lower than in 1930, average wages were 11 per cent higher, and taxes were 13 per cent higher.

The further recovery in earnings this year will enable numerous railroads to retire current and near-term maturing obligations out of cash without resort to refunding for the first time in eleven years. The final showing for this year and the trend thereafter will be affected to a large extent, of course, by the outcome of the negotiations for a general wage increase now being conducted in Chicago.

In considering the demands for higher wages, account must be taken of the possible consequence of saddling the roads with a permanently increased burden of operating costs in a period of peak traffic that cannot be counted on to last. Now is the time when the railroads ought to be utilizing their better earnings for reducing their debts and strengthening themselves both physically and financially against the time when the present business boom and defense program have come to an end. Moreover, with the prevailing heavy traffic this year and resulting wear and tear on roadway and rolling stock, the railroads will have to spend more money for maintenance and for new equipment.

United States and Argentine Trade Relations

Announcement in June that Argentina would eliminate her Exchange Control Board as of July 1, and the action taken on that date, have

been events of interest to foreign traders and a step towards closer Hemisphere cooperation. While the new regulations follow closely the procedure previously in effect, they have the advantage of permitting importers in Argentina to know definitely the classes of goods that they can purchase from different countries, and the basis on which they can pay for such imports after customers' clearance. In addition there are various classes of merchandise that can now be imported from the United States, whereas previously such goods were not accorded permits.

This action by Argentina with respect to exchange control, together with the fact that negotiations have been resumed on a trade treaty with this country, renders timely a reference to the Argentine situation and trade policies.

The modification of exchange control has followed the accumulation of substantial amounts of dollars as a result of increased sales to the United States. These sales lifted Argentina's exports to us in the January-June period to 263,000,000 pesos, or some 110 per cent above last year's level, and made us her best customer. The export balance which Argentina accumulated in her trade with us in the first half of 1941 came to 171,000,000 pesos, against the deficit of 38,000,000 pesos in the same period last year. Although Argentina's total trade has been considerably smaller than last year, her aggregate export balance was 226,000,000 pesos, compared with 94,000,000 last year.

Our own national defense program and our expanding civilian consumption stimulated the purchase of Argentina's canned beef, hides, and linseed, and brought the bulk of her wool crop here at good prices.

At the same time, Argentine imports from the United States have been on a level only two-thirds that of the average for the 1937-1939 period. This was due to Argentine import and exchange control heretofore in effect, scarcity of shipping space, and the interference of our own defense program with export shipments.

Negotiations for a Trade Treaty

The modification of exchange restrictions and the expected utilization of our credits by Argentina should improve the trade between the two countries. Although certain controls are retained, there is expected to be a general expansion in imports of much needed industrial and transport equipment and other goods now available only in this country.

This freeing of trade comes at an opportune time, for the reason that economic difficulties produced by the war in Europe have begun to affect the hitherto satisfactory internal business situation in Argentina. The drastic reduction of imports has curtailed the business of importers and other distributors of foreign merchandise, and has retarded the progress of industrialization. At the same time the loss of continental markets has created a difficult situation in agriculture which the Government has been endeavoring to relieve through purchases of crop surpluses of wheat, corn, linseed and barley. The harvest, just completed, of one of the largest corn crops on record has intensified the problem of dealing with agricultural surpluses and will mean an additional burden upon the national economy.

As a result of our increased purchases from Argentina and the general world situation, the renewal of negotiations for a trade agreement with the United States is quite opportune. The competitive character of American and Argentine exports has prevented the legislators in both countries from agreeing upon a trade treaty ever since the 1870s. The last time, in 1939, the negotiations broke down because of the inability of both parties to agree upon necessary concessions.

The extension of the war has tempered the attitude of both countries, besides making them realize the need of cooperation for common good in the New World. The United States, because of the enlarged needs of the national defense program and expanding consumption at home, is finding it possible to absorb increased quantities of Argentine products without injury to domestic producers. As a long-range program, the United States is exploring the possibilities for continuing moderate importation of standard products in such quantities as will not in fact prove to be competitively injurious, and for developing new products that can be imported on a non-competitive basis.

The satisfactory negotiation of a trade agreement with Argentina would round out the program of closer economic collaboration throughout the Western Hemisphere. Argentina has the largest foreign trade of all Latin-American countries, and is one of the most advanced industrially. Despite the impact of the depression, she has maintained her foreign debt service and reduced her external debt.

There is gratifying evidence that Argentina is regarding her relations with the United States in the light of new conditions now prevailing in the world, and that she too is anxious for a better mutual understanding. This changing attitude was voiced by Dr. Federico Pinedo, former Argentine Minister of Finance, now visiting in this country as follows:

> "The unequivocal sentiment of the immense majority of the Argentine people and the considered judgment of the best Argentine minds coincide in demanding the closest relations between our country and this nation. We are under the obligation of redressing as soon as possible and as completely as we may be able to, the consequences of the relative isolation in which we have lived with regard to one another. And this must be done not only in compliance with the Pan-American ideal but for the permanent and positive interests of our own countries, interests which have become only too obvious, except for the blind, by the sinister glare of the war".

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